

**Statement of Keith Collins
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U.S. Department of Agriculture
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Mr. Chairman and Members of the Committee, I appreciate the opportunity to appear before you at this hearing on tax policies of importance to farmers. With me today is Ron Durst, U.S. Department of Agriculture's (USDA) expert in farm tax issues. Our goal today is to present basic information on the major taxes of interest to U.S. agriculture. In my remarks, I will identify these taxes, particularly estate and capital gains taxes, and indicate their importance to U.S. agricultural producers. I will also discuss the implications for U.S. agricultural producers of the Administration's FY 1998 budget proposals affecting the capital gains tax and estate tax. USDA does not have the Administration lead on tax policy; therefore, any issues related to tax policy would have to be addressed by the Department of Treasury.

Taxes Affecting U.S. Farmers

Farmers like other taxpayers are subject to a variety of taxes at all levels of government. To put the different types of taxes in an overall context, the major taxes paid by farm sole proprietors total between \$25 and \$30 billion annually. At the Federal level, these taxes include the Federal income and self-employment taxes as well as Federal estate and gift taxes. Federal taxes account for about two-thirds of the total taxes paid by farm sole proprietors. Of these, the Federal income tax is the most important. In 1993, the most recent year for which data are available, farm sole proprietors paid \$16.0 billion in Federal income taxes on their farm and nonfarm income, including capital gains from the sale of farmland and other assets. They paid an

additional \$1.9 billion in self-employment taxes. Farm partnerships and corporations undoubtedly paid substantial Federal income and payroll taxes as well. However, insufficient information exists to provide a reliable estimate of these taxes.

Federal estate and gift taxes in comparison to the Federal income and self-employment taxes are relatively small. Based on a recent analysis of farm level survey data, Federal estate and gift taxes paid by persons with farms were estimated at about \$500 million. However, as will be discussed later, this does not mean that Federal estate and gift tax policies are of little importance to the farming community.

State and local taxes account for about one-third of the taxes paid by farm sole proprietors. The major taxes are state and local income taxes which total about \$3.5-\$4.0 billion per year and real estate and other property taxes which account for about \$4 billion per year.

Federal Estate and Gift Taxation

Federal estate and gift taxes represent only about 1 percent of total Federal revenues with total Federal estate and gift taxes accounting for \$17.2 billion in 1996. However, while the aggregate importance of Federal estate and gift taxes is small relative to other Federal Government revenue sources, the potential impact of these taxes on an individual or group of individuals, such as farmers, can be substantial.

The most important aspect of the Federal estate tax which largely determines the percentage of estates subject to the tax is the unified credit, which provides an exemption from the estate tax for most estates. The unified credit was increased substantially from 1981 to 1987 but has not been changed since 1987. The current credit is equal to \$192,800 which, under the current tax rate structure, exempts the first \$600,000 of an estate. As a result of the credit, with

only minimal planning, a married couple should be able to transfer a minimum of \$1.2 million in assets to their heirs without incurring Federal estate and gift taxes. About 5 percent of U.S. farms have a net worth in excess of \$1.2 million.

The importance of the unified credit for farmers can be illustrated by examining the size of farm that can be transferred without incurring any Federal estate tax. In 1981, based on U.S. average values for farm real estate, the unified credit allowed 214 acres of farm real estate to be transferred tax-free. By 1987, as a result of the drop in farmland values and the substantial increase in the credit, about 1,000 acres could be transferred tax-free. As a result of the recovery in land values over the last decade, today the amount of farm real estate that can be transferred tax-free has declined by 32 percent to 675 acres.

Over the years, the impact of Federal estate and gift tax policies on the ability of farmers to transfer the farming operation to the next generation has been a major concern among farmers. They have been concerned that their heirs would have to incur large debts or sell all or part of the farm to settle the estate. It was precisely this concern that led to the enactment of the special use valuation provision available to farmers and other small businesses. This special valuation provision allows farmers to value their farmland at its farm value rather than its fair market value, which may reflect development potential for non-farm use. While the savings from the special use valuation provision vary, in many instances the value of the real estate portion of the estate can be cut in half. While the total reduction in the value of the farm estate is limited to \$750,000, relatively few farm estates are affected by this limit. Based on 1994 IRS data, the average reduction in value for Federal estate tax purposes for those electing special use valuation was \$343,000.

The level of savings available under the special use valuation provision makes it a very valuable estate planning tool. However, restrictions incorporated into the special use value law make compliance costly and complicated. These restrictions are designed to limit benefits to the estates of individuals who were actively engaged in farming and whose heirs will continue farming. Furthermore, benefits of the special use valuation provision vary by region and are greatest for those estates comprised primarily of land compared to those with farm machinery and other types of property.

Despite the availability of the special use value provision, a larger share of farmers compared to other taxpayers continue to be subject to the Federal estate tax. While just over 1 percent of all estates are taxable, individuals with farm property account for between 6 and 7 percent of these taxable estates. A recent study by USDA's Economic Research Service, examining the impact of Federal estate and gift taxes on farmers, found that an estimated 6 percent of farm estates end up owing Federal estate and gift taxes.

The study, based on 1994 farm-level survey data, found that the average estate of about \$461,000 could easily be transferred to the heirs of the estate free of Federal estate tax liability with little or no planning. However, the analysis suggested that there are a large number of farm estates with assets well above the current \$600,000 unified credit exemption. Using the 1994 data, the study estimated the number of farm estates at 29,340 with 4,150 having gross assets in excess of \$600,000. However, after deductions, only 1,714 of these estates were taxable. The average Federal estate tax for these estates was estimated at \$285,000. Given an average net worth of \$1,587,000, this resulted in an average tax rate of about 18 percent. The special use valuation provision was found to be especially important in reducing both the level of taxes and

the number of taxable estates. The provision reduced both the number of taxable estates and total Federal estate and gift taxes for all farm estates by about one-third.

Federal estate taxes are normally payable within 9 months after the date of death. With an average tax rate of 18 percent and over 75 percent of the farm estate's assets consisting of farm real estate and other farm assets that could not be easily liquidated without disrupting the farm business, many of those farm estates subject to the tax could face a liquidity problem. This liquidity problem is reduced somewhat by the availability of an installment payment provision. To qualify, at least 35 percent of the value of the estate must be a farm or other closely held business interest. Under the provision, estate taxes may be paid over a 14-year period with interest only for the first 4 years and equal principal and interest payments over the last 10 years. A special 4 percent interest rate applies to the taxes due on the first \$1 million in value of the farm or other closely held business with the regular interest rate applicable to tax underpayments on amounts over \$1 million. In some instances, this provision can be the difference between the liquidation and the continuation of the farm business. Based on 1994 IRS data, the average Federal estate tax deferred by those estates with farmland who elected the installment payment provision was about \$836,000.

Administration's Proposal to Ease Estate Tax Burden

In order to address the liquidity problem that estates containing farm and other closely-held businesses often face, the Administration has proposed a number of changes to the installment payment provision. The \$1,000,000 million cap on the 4-percent interest rate has been in effect since 1976. The Administration's proposal would increase the value of the farm or other closely-held businesses eligible for the special low interest rate from \$1 million to \$2.5 million.

The current 4-percent interest rate would be cut to 2 percent and the rate on the amount over \$2.5 million would be reduced to 45 percent of the normal interest rate on tax underpayments. Interest paid on the deferred estate tax would not be deductible for either estate or income tax purpose. The types of businesses eligible for the installment payment provision would be expanded by making the form of business ownership irrelevant. The Secretary of the Treasury would also be allowed to accept security arrangements in lieu of the special estate tax lien which has in some cases made it difficult for heirs to obtain credit to finance the day-to-day operations of the farm business.

Capital Gains Taxation

The subject of tomorrow's hearing is capital gains taxes, so I would like to comment briefly on these taxes and their implications for agriculture. Under current law, nominal capital gains are included in income upon realization. For taxpayers in the 15 and 28 percent brackets, gains are fully taxed at ordinary income tax rates. Individuals in the 31, 36, and 39.6 percent tax brackets pay a maximum capital gains tax rate of 28 percent. The 28 percent maximum rate effectively provides exclusions of 10, 22 and 29 percent for individuals in the 31, 36, and 39.6 percent tax brackets, respectively.

Since assets used in a trade or business, including farming, are eligible for capital gains treatment, policies aimed at lowering the tax rate on capital assets have important implications for farmers. Agricultural assets eligible for such treatment primarily include breeding and dairy livestock and farmland.

As a result of this treatment, the realization of a capital gains is an important component of income for farmers. In 1993, one-third of all farm sole proprietors reported capital gains. This

is about 3 times the rate for all taxpayers. The average capital gain reported was \$14,900 for a total of \$12.0 billion. Nearly half of these gains were from assets used in farming. A lower tax rate of capital gains would reduce Federal income tax liability and raise after-tax income for many farmers.

In 1993, farm sole proprietors paid an estimated \$2.4 billion in Federal income taxes on gains from the sale of capital assets. The restoration of a 50 percent exclusion for capital gains would lower Federal income tax liability for farm sole proprietors by an estimated \$1 billion. However, a large portion of the resulting tax reductions would accrue to relatively high income individuals. In 1993, 56 percent of all capital gains reported by farm sole proprietors was reported by those with adjusted gross incomes over \$100,000. Gains from the sale of assets used in farming are more widely distributed, with only about 40 percent of these gains reported by such farmers.

One of the alternatives suggested for reducing the tax rate on capital gains is indexing the basis of capital assets for inflation. Indexing would ensure that only real gains, not inflationary gains, would be subject to taxation. The primary benefits of indexing in agriculture would accrue to owners of farmland held for long periods of time since a large part of the increase in value is often attributed to inflation. Other farm assets eligible for capital gains treatment, such as livestock, generally have a zero basis and would not benefit from indexation.

For example, based on average U.S. values, an acre of farm real estate purchased in 1966 and held for 30 years would have increased in value from about \$158 to \$890 for a \$732 per acre gain. However, of this \$732 nominal gain, only about \$167, or about one-fourth, represents a real increase in value. In fact, at a 28 percent Federal income tax rate the tax liability on the sale

would be \$205, substantially more than the real increase in value. Taxing only the real gain would cut the tax liability to \$47.

The effect of this large unrealized gain on farmland held for long periods in combination with the step-up in the basis of assets at death is to discourage sales. This restricts the availability of land for purchase but may increase the amount of land available for rent.

Administration's Capital Gains Proposal

The Administration would replace the current provision that allows the rollover of gain from the sale of a principal residence into a new residence and the one-time \$125,000 exclusion for individuals 55 years or older with a new larger exclusion. This exclusion would allow a married couple who have owned a home and occupied it as a principal residence for at least 2 out of the last 5 years to exclude up to \$500,000 in gain on the sale or exchange of such residence. This would exempt over 99 percent of home sales from capital gains taxes. The farm residence portion of the farm would be eligible for this new exclusion.

Conclusion

In conclusion, U.S. farmers face a variety of taxes. Of the total taxes paid by farm sole proprietors, estate and capital gains taxes account for a relatively small share. Even so, these taxes can affect farm ownership and management. Attempts to eliminate or reduce these effects through tax changes would require offsetting changes in other taxes or expenditures. It should also be noted that the special use valuation and tax deferred provisions for estate taxes for farms result in an annual revenue loss to the Treasury in excess of \$100 million.

That completes my testimony, and we will be happy to respond to questions.